

China Direct Industries, Inc.  
Form 10-Q  
February 12, 2010

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the quarterly period ended December 31, 2009

or

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-33694

CHINA DIRECT INDUSTRIES, INC.  
(Exact name of registrant as specified in its charter)

Florida  
(State or other jurisdiction of incorporation or  
organization)

13-3876100  
(I.R.S. Employer Identification No.)

431 Fairway Drive, Suite 200, Deerfield Beach, Florida  
(Address of principal executive offices)

33441  
(Zip Code)

954-363-7333  
(Registrant's telephone number, including area code)

Not Applicable  
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

(Do not check if smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes  No

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date. 27,627,878 shares of common stock were issued and outstanding as of February 9, 2010.

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## INDEX OF CERTAIN DEFINED TERMS USED IN THIS REPORT

When used in this report the terms:

- “China Direct Industries”, “we”, “us” or “our” refers to China Direct Industries, Inc., a Florida corporation, and our subsidiaries;
- “CDI China”, refers to CDI China, Inc., a Florida corporation, and a wholly owned subsidiary of China Direct Industries; and
- “PRC” refers to the People’s Republic of China.

### Magnesium Segment

- “Chang Magnesium”, refers to Taiyuan Changxin Magnesium Co., Ltd., a company organized under the laws of the PRC and a 51% owned subsidiary of CDI China;
- “Chang Trading”, refers to Taiyuan Changxin YiWei Trading Co., Ltd., a company organized under the laws of the PRC and a wholly owned subsidiary of Chang Magnesium;
- “Excel Rise”, refers to Excel Rise Technology Co., Ltd., a Brunei company and a wholly owned subsidiary of Chang Magnesium;
- “CDI Magnesium”, refers to CDI Magnesium Co., Ltd., a Brunei company and a 51% owned subsidiary of Capital One Resources;
- “Asia Magnesium”, refers to Asia Magnesium Corporation Limited, a company organized under the laws of Hong Kong and a wholly owned subsidiary of Capital One Resource;
- “Golden Magnesium” refers to Shanxi Gu County Golden Magnesium Co., Ltd., a company organized under the laws of the PRC and a 52% owned subsidiary of Asia Magnesium;
- “Pan Asia Magnesium”, refers to Pan Asia Magnesium Co., Ltd., a company organized under the laws of the PRC and a 51% owned subsidiary of CDI China;
- “Baotou Changxin Magnesium”, refers to Baotou Changxin Magnesium Co., Ltd., a company organized under the laws of the PRC, a 51% owned subsidiary of CDI China, and a 39% owned subsidiary of Excel Rise. Effectively China Direct holds a 70.9% interest;
- “IMG” or “International Magnesium Group”, refers to International Magnesium Group, Inc., a Florida corporation and a 100% owned subsidiary of China Direct Industries; and
- “IMTC” or “International Magnesium Trading”, refers to International Magnesium Trading Corp., a company organized under the laws of Brunei and a 100% owned subsidiary of CDI China.

### Basic Materials Segment

- “Lang Chemical”, refers to Shanghai Lang Chemical Co., Ltd., a company organized under the laws of the PRC and a 51% owned subsidiary of CDI China;
- “CDI Jingkun Zinc”, refers to CDI Jingkun Zinc Industry Co., Ltd., a company organized under the laws of the PRC and a 95% owned subsidiary of CDI Shanghai Management;
- “CDI Jixiang Metal”, refers to CDI Jixiang Metal Co., Ltd., a company organized under the laws of the PRC and a wholly owned subsidiary of CDI China;
- “CDI Metal Recycling”, refers to Shanghai CDI Metal Recycling Co., Ltd., a company organized under the laws of the PRC and an 83% owned subsidiary of CDI Shanghai Management;
- “CDI Beijing”, refers to CDI (Beijing) International Trading Co., Ltd., a company organized under the laws of the PRC and a 51% owned subsidiary of CDI Shanghai Management; and
- “CDII Trading”, refers to CDII Trading, Inc., a Florida corporation and a 100% owned subsidiary of China Direct Industries.

## Consulting Segment

- “China Direct Investments”, refers to China Direct Investments, Inc., a Florida corporation, and a wholly owned subsidiary of China Direct;
- “CDI Shanghai Management”, refers to CDI Shanghai Management Co., Ltd., a company organized under the laws of the PRC and a wholly owned subsidiary of CDI China; and
- “Capital One Resource”, refers to Capital One Resource Co., Ltd., a Brunei company, and a wholly owned subsidiary of CDI Shanghai Management.

Clean Technology Segment: (All operations related to the following entities were discontinued in September 2008)

- “CDI Clean Technology”, refers to CDI Clean Technology Group, Inc., a Florida corporation formerly known as Jinan Alternative Energy Group Corp.. Effective October 30, 2008, CDI China holds a 19% interest;
- “CDI Wanda”, refers to Shandong CDI Wanda New Energy Co., Ltd., a company organized under the laws of the PRC and a 51% owned subsidiary of CDI Clean Technology; and
- “Yantai CDI Wanda”, refers to Yantai CDI Wanda Renewable Resources Co., Ltd., a company organized under the laws of the PRC and a 52% owned subsidiary of CDI Wanda.

The information which appears on our websites is not part of this report.

All share and per share information contained herein gives retroactive effect to the 1-for-100 shares reverse split of our common stock on September 19, 2008 which was immediately followed by a 100-for-1 forward split of our common stock.

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## PART 1 - FINANCIAL INFORMATION

## Item 1. Financial Statements.

CHINA DIRECT INDUSTRIES, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

	December 31, 2009 Unaudited	September 30, 2009
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$9,102,894	\$12,851,310
Investment in marketable securities available for sale	4,039,703	4,984,351
Investment in marketable securities available for sale - related party	585,034	604,686
Investment in subsidiaries -- cost method	290,864	290,864
Accounts receivable, net of allowance of \$ 516,610 and \$745,786 at December 31, 2009 and September 30, 2009, respectively	8,761,238	8,195,916
Accounts receivable - related parties	2,611,884	2,355,059
Inventories, net	5,605,654	5,806,722
Prepaid expenses and other current assets	8,878,990	5,092,205
Prepaid expenses - related parties	3,666,143	5,823,039
Loans receivable - related parties	1,309,069	1,094,142
Current Assets in discontinued operations (see Note 14)	51,345	51,345
Total current assets	44,902,818	47,149,639
Restricted cash	716,668	722,324
Property, plant and equipment, net	30,799,602	31,331,992
Prepaid expenses and other assets	2,494	1,836
Property use rights, net	1,101,779	1,113,902
Long-lived assets in discontinued operations (see Note 14)	196,078	196,077
Total assets	\$77,719,439	\$80,515,770
<b>LIABILITIES AND EQUITY</b>		
Current Liabilities:		
Loans payable-short term	\$1,806,295	\$1,521,002
Accounts payable and accrued expenses	8,871,035	7,708,730
Accounts payable-related parties	63,673	51,716
Advances from customers and deferred revenue	562,614	2,007,137
Other payables	2,014,973	3,072,238
Taxes payable	547,210	1,130,907
Loans payable - related parties	53,677	399,629
Current Liabilities of discontinued operations (see Note 14)	300,000	300,000
Total current liabilities	14,219,477	16,191,359
Loans payable-long term	-	-
Total liabilities	14,219,477	16,191,359
China Direct Industries, Inc. Stockholders' Equity		
Preferred Stock: \$.0001 par value, stated value \$1,000 per share; 1,006 shares	1,006,250	1,006,250

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outstanding at December 31, 2009 and September 30, 2009, respectively.		
Common Stock: \$.0001 par value; 27,420,873 and 27,189,719 outstanding at December 31, 2009 and September 30, 2009, respectively.	2,742	2,719
Additional paid-in capital	57,923,743	57,492,755
Accumulated other comprehensive income	1,589,967	1,902,221
Accumulated deficit	(15,353,430)	(14,328,732)
Total China Direct Industries, Inc. stockholders' equity	45,169,272	46,075,213
Noncontrolling interests	18,330,690	18,249,198
Total Equity	63,499,962	64,324,411
Total liabilities and equity	\$77,719,439	\$80,515,770

The accompanying notes are an integral part of these consolidated financial statements.

CHINA DIRECT INDUSTRIES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)

	Three Months ended December 31, 2009	Three months ended December 31, 2008 Restated
Revenues	\$19,810,732	\$25,350,809
Revenues-related parties	2,441,797	13,605,642
Total revenues	22,252,529	38,956,451
Cost of revenues	20,428,311	40,022,618
Gross profit	1,824,218	(1,066,167 )
Operating expense:		
Selling, general, and administrative	2,793,503	3,669,840
Operating loss	(969,285 )	(4,736,007 )
Other (expense) income:		
Other (expense) income	(47,686 )	10,659
Interest expense	(1,001 )	(57,472 )
Realized gain (loss) on sale of marketable securities	34,691	(98,818 )
Realized loss on other than temporary impairment	-	(7,521,088 )
Realized gain on sale of subsidiaries	-	238,671
Total other expenses	(13,996 )	(7,428,048 )
Net loss from continuing operations before income taxes	(983,281 )	(12,164,055)
Income tax benefits	110,373	107,891
Net loss from continuing operations, net of income taxed	(872,908 )	(12,056,164)
Loss from discontinued operations	-	(916,244 )
Net loss	\$(872,908 )	\$(12,972,408)
Net (income) loss attributable to noncontrolling interests		
-continuing operations	(111,608 )	2,375,357
Net loss attributable to noncontrolling interests		
-discontinued operations	-	448,961
Net loss attributable to China Direct Industries, Inc.	\$(984,516 )	\$(10,148,090)
Deduct dividends on Series A Preferred Stock:		
Preferred stock dividend	(40,183 )	(20,235 )
Net loss attributable to common stockholders	\$(1,024,699 )	\$(10,168,325)
Basic and diluted loss per common share		
Basic	\$(0.04 )	\$(0.43 )
Diluted	\$(0.04 )	\$(0.43 )
Basic weighted average common shares outstanding	27,381,946	23,494,180
Diluted weighted average common shares outstanding	27,381,946	23,494,180

The accompanying notes are an integral part of these consolidated financial statements.

CHINA DIRECT INDUSTRIES INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF EQUITY

(Unaudited)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Comprehensive Income	Retained Earnings	Non-controlling interests	Tot
	Shares	Amount	Shares	Amount					
Balance, September 30, 2009	1,006	\$1,006,250	27,189,719	\$2,719	\$57,492,756	\$1,902,221	\$(14,328,732)	\$18,249,198	\$64,322,000
Dividends paid to preferred stockholders	-	-	12,204	1	40,183	-	(40,183)	-	1
Stock sold	-	-	34,000	3	52,394	-	-	-	52,397
Restricted stock award - employees	-	-	22,200	2	125,201	-	-	-	125,203
Restricted stock award - consultants	-	-	-	-	16,668	-	-	-	16,668
Restricted stock award - Board of Directors	-	-	27,750	3	24,370	-	-	-	24,373
Stock option amortized	-	-	-	-	18,288	-	-	-	18,288
Stock warrants exercised	-	-	135,000	14	153,883	-	-	-	153,897
Noncontrolling interests	-	-	-	-	-	-	-	81,492	81,492
Net loss for the quarter ended December 31, 2009	-	-	-	-	-	-	(984,516)	-	(984,516)
Foreign currency translation gain	-	-	-	-	-	(44,447)	-	-	(44,447)
Unrealized loss on marketable securities AFS	-	-	-	-	-	(267,807)	-	-	(267,807)
Balance, December 31,	1,006	\$1,006,250	27,420,873	\$2,742	\$57,923,743	\$1,589,967	\$(15,353,431)	\$18,330,690	\$63,499,862

2009

The accompanying notes are an integral part of these consolidated financial statements.

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CHINA DIRECT INDUSTRIES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	For the three months ended December 31,	
	2009	2008
<b>CASH FLOWS - OPERATING ACTIVITIES</b>		
Net loss	\$(872,908 )	\$(12,972,408)
Loss from discontinued operations	-	916,244
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	520,458	287,058
Allowance for bad debt	(229,176 )	161,869
Stock based compensation	167,865	530,867
Realized (gain) loss on sale of investment in marketable securities	(34,379 )	98,818
Realized gain on sale of subsidiaries	-	(238,670 )
Realized loss on investment in marketable securities	-	7,521,088
Fair value of securities received for services and interest	-	(5,032,000 )
Fair value of securities paid for services	16,668	-
Changes in operating assets and liabilities:		
Prepaid expenses and other assets	(3,942,998 )	8,914,613
Prepaid expenses - related parties	2,127,644	(254,108 )
Inventories	201,068	6,085,776
Accounts receivable	(336,146 )	8,399,078
Accounts receivable - related parties	(256,825 )	(925,772 )
Deferred compensation	155,556	-
Accounts payable and accrued expenses	1,162,305	(1,164,239 )
Accounts payable - related party	11,957	4,230,974
Advances from customers	(1,340,399 )	(5,007,483 )
Deferred revenue	(104,124 )	
Other payables	(1,057,265 )	(2,167,703 )
Taxes payable	(583,697 )	(376,943 )
Net cash (used in) provided by continuing operations	(4,394,396 )	9,007,059
Net cash provided by discontinued operations - Wanda	-	511,448
Net cash provided by discontinued operations - Pan Asia	-	3,701,335
<b>CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES</b>	<b>(4,394,396 )</b>	<b>13,219,842</b>
<b>CASH FLOWS - INVESTING ACTIVITIES</b>		
Notes receivable	-	(942,713 )
Loans receivable	-	1,531,138
Loans receivable - related party	(214,927 )	1,731,808
Proceeds from the sale of marketable securities available for sale	705,420	79,064
Purchases of property, plant and equipment	-	(15,799,492)
Net cash provided by (used in) investing activities - continuing operations	490,493	(13,400,195)
Net cash used in investing activities - discontinued operations	-	(4,565,644 )
<b>CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES</b>	<b>490,493</b>	<b>(17,965,839)</b>
<b>CASH FLOWS - FINANCING ACTIVITIES</b>		

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Restricted cash	5,656	(844,777 )
Loans payable	285,293	(3,168,317 )
Due from related parties	-	389,226
Due to related parties	(345,952 )	531,415
Gross proceeds from sale of common stock	52,397	-
Proceeds from exercise of warrants	153,897	-
Cash payment for reverse/forward stock split and stock repurchase	-	(395,043 )
Capital contribution from noncontrolling interest owners	-	1,485,544
Cash provided by (used in) financing activities - continuing operations	151,291	(2,001,952 )
Cash provided by financing activities - discontinued operations	-	1,182,536
<b>CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES</b>	<b>151,291</b>	<b>(819,416 )</b>
<b>EFFECT OF EXCHANGE RATE ON CASH</b>	<b>4,196</b>	<b>133,780</b>
Net decrease in cash	(3,748,416 )	(5,431,633 )
Cash and equivalents, beginning of period-continuing operations	12,851,310	19,097,265
Cash and equivalents, beginning of period-discontinued operations	-	539,597
Cash and equivalents, beginning of the period	12,851,310	19,636,862
Cash and equivalents, end of period	9,102,894	14,205,229
Less cash and equivalents of discontinued operations, end of period	-	205,044
Cash and equivalents of continuing operations, end of period	\$9,102,894	\$14,000,185
<b>Supplemental disclosures of cash flow information:</b>		
Dividend payment in stock to preferred stockshareholders	\$40,183	\$80,925

The accompanying notes are an integral part of these consolidated financial statements.

CHINA DIRECT INDUSTRIES, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2009

NOTE 1 - ORGANIZATION AND DESCRIPTION OF BUSINESS

Business and Organization

China Direct Industries, Inc., a Florida corporation and its subsidiaries are referred to in this report as “we”, “us”, “our”, or “China Direct”.

We are a U.S. company that manages a portfolio of Chinese entities. We also provide consulting services to Chinese businesses. We operate in three identifiable segments, Magnesium, Basic Materials and Consulting in accordance with the Financial Standard Board Accounting Standard Codifications (“ASC”) 280, “Segment Reporting.” In 2006 we established our Magnesium and Basic Materials segments which have grown through acquisitions of controlling interests of Chinese private companies. We consolidate these acquisitions as either wholly or majority owned subsidiaries. Through this ownership control, we provide management advice, business development services, strategic planning, macroeconomic industry analysis and financial management seeking to improve the quality and performance of each portfolio company. We also provide our subsidiaries with investment capital to expand their businesses.

In our Magnesium segment we produce, sell and distribute pure magnesium ingots, magnesium powders and magnesium scraps.

In our Basic Materials segment, we sell and distribute a variety of products including industrial grade synthetic chemicals, steel products, non ferrous metals, recycled materials, and industrial commodities. This segment also includes our zinc ore mining property and zinc concentrate distribution businesses which have not commenced operations.

In our Consulting segment, we provide a suite of consulting services to U.S. public companies that operate primarily in China. The consulting fees we charge vary based upon the scope of the services to be rendered.

We discontinued our Clean Technology segment which we launched in fiscal 2007 when we completed the sale of our 81% interest in CDI Clean Technology and its subsidiaries, CDI Wanda and Yantai CDI Wanda to PE Brothers Corp. in the third quarter of fiscal 2008 for \$1,240,000 and recorded a gain on the sale of \$238,670. The sale was finalized in October 2008. We account for our remaining 19% ownership interest in CDI Clean Technology using the cost method of accounting.

In the second quarter of the 2009 transition period (as defined later in this report) China Direct formed International Magnesium Group, as our wholly owned subsidiary to consolidate our magnesium holdings under one corporate entity and to create an identifiable brand name to unify marketing efforts for these operations.

In July 2009 we formed CDI Trading, as our wholly owned subsidiary to engage in the global purchases and sales of industrial commodities for us and our subsidiaries and client companies. CDI Trading focuses its efforts in North and South America, Russia, parts of Africa and the European Union. CDI Trading will seek to market products from China Direct and our various business units as well as market and procure products for its consulting clients. CDI Trading will also seek to leverage our relationships in China and other countries to opportunistically trade additional complementary products for its end customers.

On September 29, 2009 our board of directors committed to a plan to sell our 51% interest in Pan Asia Magnesium and our interest in CDI Magnesium which is presented in these consolidated financial statements as a discontinued operation. See Note 14 - Discontinued Operations.

In October 2009 we formed International Magnesium Trading as a wholly owned subsidiary of International Trading Group to engage in the trading of magnesium products.

CHINA DIRECT INDUSTRIES, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2009

## NOTE 2 - BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

## Restatement of financial statements disclosure

The December 31, 2008 financial statements included in our Form 10-K filed on March 31, 2009, contained an error related to the method of calculating the other-than-temporary impairment of available for sale securities. Accordingly, the consolidated balance sheets, consolidated statements of operations, consolidated statement of stockholders' equity, and consolidated statement of cash flows for fiscal 2008 have been restated in our Transition Report on Form 10-K for the nine month period ended September 30, 2009 (the "2009 Transition Report on Form 10-K") to correct the accounting treatment previously accorded the other-than-temporary impairment transaction. Furthermore, we discontinued a component of our business which also affected our financial statements for the year ended December 31, 2008 included in the 2009 Transition Report on Form 10-K.

The effect of correcting this error and the discontinued operations on our consolidated balance sheet at December 31, 2008, and consolidated statement of operations and statement of cash flows for the three months ended December 31, 2008 is shown in the table below. There was no net effect on comprehensive income from this error and all other changes to our consolidated statement of equity will be shown in the tables provided for in the consolidated balance sheet and consolidated statement of operations. Additionally, for accounts effected by the restatement error, adjustments related to the retrospective presentation of discontinued operations are also shown.

Consolidated Balance Sheet Data	December 31, 2008		
	Unadjusted(1)	Adjustment to Restate	Restated
Shareholders' equity			
Accumulated other comprehensive (loss) income	\$ (11,711,021)	\$ 3,393,533	(8,317,488 )
Retained Earnings	\$ 17,037,407	\$ (3,393,533)	13,643,874
Consolidated Statements of Operations Data	For the three months ended December 31, 2008		
	Unadjusted(1)	Adjustment to Restate	Restated
Realized loss on Other Than Temporary Impairment	\$ (4,127,555 )	\$ (3,393,533)	\$ (7,521,088 )
Total other expense	\$ (4,034,515 )	\$ (3,393,533)	\$ (7,428,048 )
Net loss from continuing operations before income taxes	\$ (8,770,522 )	\$ (3,393,533)	\$ (12,164,055)
Net loss from continuing operations net of income taxes	\$ (8,662,631 )	\$ (3,393,533)	\$ (12,056,164)
Net loss	\$ (9,578,875 )	\$ (3,393,533)	\$ (12,972,408)
Net loss attributable to China Direct Industries, Inc.	\$ (6,754,557 )	\$ (3,393,533)	\$ (10,148,090)
Net loss applicable to common stockholders	\$ (6,774,792 )	\$ (3,393,533)	\$ (10,168,325)
Basic and diluted loss per common share:			
Basic	\$ (0.29 )	\$ (0.14 )	\$ (0.43 )
Diluted	\$ (0.29 )	\$ (0.14 )	\$ (0.43 )

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Consolidated Statements of Cash Flows Data	For the three months ended December 31, 2008		
	Unadjusted	Adjustment to Restate	Restated
Net loss	\$ (9,578,875 )	\$ (3,393,533)	\$ (12,972,408)
Realized loss on investment in marketable securities - Other Than Temporary Impairment	\$ 4,127,555	\$ 3,393,533	\$ 7,521,088

Consolidated Statement of Changes in Equity	For the three months ended December 31, 2008		
	Unadjusted	Adjustment to Restate	Restated
Net loss	\$ (6,754,557 )	\$ (3,393,533)	\$ (10,148,090)
Unrealized (loss) gain on marketable securities available for sale	\$ (2,116,075 )	\$ 3,393,533	\$ 1,277,458

(1) The unadjusted amounts were included in the consolidated statement of operations for the fiscal year ended December 31, 2008 included in our Form 10-K filed on March 31, 2009. These amounts were not, however, reflected on a standalone basis for the three month period ended December 31, 2008.

CHINA DIRECT INDUSTRIES, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2009

Basis of Presentation

Change in Fiscal Year

Effective August 13, 2009, we changed our fiscal year end from December 31 to September 30. We have defined various periods that are covered in this report as follows:

- “fiscal 2010” — October 1, 2009 through September 30, 2010.
- “2009 transition period” — January 1, 2009 through September 30, 2009.
- “fiscal 2008” — January 1, 2008 through December 31, 2008.
- “fiscal 2007” — January 1, 2007 through December 31, 2007.

Our unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and pursuant to the requirements for reporting on Form 10-Q. Accordingly, the unaudited consolidated financial statements do not include all the information and footnotes required by U.S. generally accepted accounting principles for annual financial statements. However, the information included in these interim financial statements reflect all adjustments (consisting solely of normal recurring adjustments) which are, in the opinion of management, necessary for the fair presentation of the consolidated financial position and the consolidated results of operations. Results shown for interim periods are not necessarily indicative of the results to be obtained for a full year. The consolidated balance sheet information as of September 30, 2009 was derived from the audited consolidated financial statements included in our 2009 Transition Report on Form 10-K. These interim financial statements should be read in conjunction with our 2009 Transition Report on Form 10-K. Certain reclassifications have been made to prior year amounts to conform to the current year presentation and to disclose our reclassification of discontinued operations treatment of Pan Asia Magnesium and CDI Magnesium and the sale of an 81% interest in CDI Clean Technology.

Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant estimates for the periods reported include the investments held for sale, the allowance for doubtful accounts of accounts receivable, the fair value of stock-based compensation, and the useful life of property, plant and equipment.

We rely on assumptions such as volatility, forfeiture rate, and expected dividend yield when deriving the grant date fair value of share-based compensation. If an equity award is modified, and we expect the service conditions of the original award will be met, we will adjust our assumptions and estimates as of the modification date and compare the old equity award valued at the modification date with the new equity award valued at the modification date to calculate any incremental cost. We then continue to recognize the original grant date fair value plus any incremental cost over the modified service period.

Our estimate for allowance for doubtful accounts is based on an evaluation of our outstanding accounts receivable including the age of amounts due, the financial condition of our specific customers, knowledge of our industry segment in the PRC, and historical bad debt experience. This evaluation methodology has proven to provide a reasonable estimate of bad debt expense in the past and we intend to continue to employ this approach in our analysis

of collectability. However, we are aware that given the current global economic situation, including that of the PRC, meaningful time horizons may change. We intend to enhance our focus on the evaluation of our customers' sustainability and adjust our estimates as may be indicated.

We group property plant and equipment into similar groups of assets and estimate the useful life of each group of assets. See Note 7 – Property and Equipment for further information on asset groups and estimated useful lives.

Assumptions and estimates employed in these areas are material to our reported financial conditions and results of operations. These assumptions and estimates have been materially accurate in the past and are not expected to materially change in the future. Actual results could differ from these estimates.

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### Cash and Cash Equivalents

For purposes of the consolidated statements of cash flows, we consider all highly liquid investments with original maturities of three months or less to be cash equivalents. The carrying values of these investments approximate their fair value.

### Concentration of Credit Risks

Financial instruments which potentially subject us to concentrations of credit risk consist principally of cash and trade accounts receivable. We deposit our cash with high credit quality financial institutions in the United States and China. As of December 31, 2009, bank deposits in the United States exceeded federally insured limits by \$500,000. At December 31, 2009, we had deposits of \$4,144,392 in banks in China. In China, there is no equivalent federal deposit insurance as in the United States, so the amounts held in banks in China are not insured. We have not experienced any losses in such bank accounts through December 31, 2009.

At December 31, 2009 and September 30, 2009, bank deposits by geographic area were as follows:

Country	December 31, 2009			September 30, 2009		
United States	\$ 4,958,502	54	%	\$ 8,625,782	67	%
China	4,144,392	46	%	4,225,528	33	%
Total Cash and cash equivalents	\$ 9,102,894	100	%	\$ 12,851,310	100	%

In an effort to mitigate any potential risk, we periodically evaluate the credit quality of the financial institutions at which we hold deposits, both in the United States and China.

### Accounts Receivable

Accounts receivable are reported at net realizable value. We have established an allowance for doubtful accounts based upon factors pertaining to the credit risks of specific customers, historical trends, age of the receivable and other information. Delinquent accounts are written off when it is determined that the amounts are uncollectible. At December 31, 2009 and September 30, 2009, allowances for doubtful accounts were \$516,610 and \$745,786, respectively.

### Inventories

Inventories, consisting of raw materials and finished goods, are stated at the lower of cost or market utilizing the weighted average method. Inventories as of December 31, 2009 and September 30, 2009 were \$5,605,654 and \$5,806,722, respectively. Due to the nature of our business and the short duration of the manufacturing process of our products, there was no work-in-process inventory at December 31, 2009 and September 30, 2009.

### Accounts Payable-Related Parties

At December 31, 2009 our consolidated balance sheet reflects accounts payable-related parties of \$63,673. At September 30, 2009, our consolidated balance sheet reflects accounts payable-related parties of \$51,716. Accounts payable-related parties are discussed in further detail in Note 10 - Related Party Transactions.

Fair Value of Financial Instruments

As of January 1, 2008, we adopted on a prospective basis certain required provisions of Topic 820, "Fair Value Measurements". Those provisions relate to our financial assets and liabilities carried at fair value and our fair value disclosures related to financial assets and liabilities. Topic 820 defines fair value, expands related disclosure requirements and specifies a hierarchy of valuation techniques based on the nature of the inputs used to develop the fair value measures. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

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There are three levels of inputs to fair value measurements - Level 1, meaning the use of quoted prices for identical instruments in active markets; Level 2, meaning the use of quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in markets that are not active or are directly or indirectly observable; and Level 3, meaning the use of unobservable inputs. Observable market data should be used when available.

All of our financial instruments are carried at fair value, including, all of our cash equivalents, investments classified as available for sale securities and assets held for sale, with unrealized gains or losses, net of tax. Virtually all of our valuation measurements are Level 1 measurements. The adoption of Topic 820 did not have a significant impact on our consolidated financial statements.

#### Marketable Securities

Marketable securities held for sale and marketable securities held for sale-related party at December 31, 2009 and September 30, 2009 consists of the following:

Company	December 31,		September	
	2009	% of total	30, 2009	% of total
China America Holdings, Inc.	\$ 540,201	12 %	\$ 540,200	10 %
China Logistics Group, Inc.	761,000	16 %	761,000	14 %
Dragon International Group Corp.	36,506	1 %	228,158	4 %
China Armco Metals, Inc.	2,515,835	54 %	3,116,993	55 %
Sunwin International Neutraceuticals, Inc.	186,161	4 %	338,000	6 %
Dragon Capital Group Corp.				